

DATE: September 10, 2004

TO: Brett Dahl, Administrator

FROM: Kristie Rhodes, Risk Finance Specialist

RE: 2003 Cost of Risk/Benchmark Analysis

The 2003 Cost of Risk Benchmark Analysis is complete. The 2003 RIMS Benchmark Survey™ is the first written summary of the results of a continuous data collection and analysis process conducted by Advisen Ltd. The electronic survey replaces the paper-focused survey conducted in the past by Ernst & Young and its predecessors. The RIMS Benchmark Survey™ was not completed for 2002 due to the implementation of the online system therefore the 2003 report was used for this analysis as well as the 2002 analysis.

The 2003 survey was completed by 787 respondents. 63 of the respondents were government entities, the fifth largest group in this year's survey, against which RMTD is measured in this analysis. Revenue size could not be compared with that of other industries because respondents used a net operating budget as their primary exposure base. Most of the larger respondents in the government group (defined as those with operating budgets greater than \$1 billion) are state governments, large cities, and very large counties. The State of Montana falls into this category with an operating budget of over \$5 billion.

The total cost of risk and composition of the cost of risk dollar statistics presented in this report, as well as the data displayed in charts and graphs were obtained from the 2003 RIMS Benchmark Survey™, RMTD FY2003 SABHRS reports, Office of Budget and Program Planning and the Montana State Fund. This benchmark schedule compares Montana to other governmental respondents and uses the governmental industry median numbers presented in the survey.

Most of the trends and developments captured by the 2003 RIMS Benchmark Survey™ should not be surprising to risk managers and other insurance professionals. Premiums have overall increased dramatically since 2001. Insurance costs for every line of business have, on average, nearly doubled during that period, and tripled (or more) for a few hard hit lines. Average retentions have risen significantly. Buyers are increasingly taking advantage of captives and other alternatives to traditional insurance to manage costs and fill gaps in coverage.<sup>1</sup>

Beginning with tentative rate increases in a few lines in 1999, and reaching full steam by the end of 2001, the insurance industry is deep into the hardest market since the mid-1980s. Buyers have been faced with consecutive double-digit rate hikes in many insurance lines, and triple-digit increase in a few lines. Coverage terms have tightened, and some distressed lines have experienced capacity shortages. The current hard market comes on the heels of one of the

longest and deepest soft markets in history. For over a decade insurance buyers enjoyed relentless price competition fueled by a powerful, sustained bull investment market that encouraged insurers to offset underwriting losses with investment income and capital gains. While the insurance market showed signs of turning as early as 1999, a confluence of events in 2001 and 2002 – the September 11 terrorist attacks, the collapse of the stock market and the subsequent fall in interest rates, a resurgence of asbestos claims, and a wave of corporate governance scandals beginning with Enron led to a rapid reversal in pricing.<sup>ii</sup>

The most current 2003 RIMS Benchmark Survey™ data indicates that rates are stabilizing in many casualty lines of business and are softening in property lines. The end of the hard market is heralded by a number of other factors. In short, a seemingly well-capitalized industry, greater market efficiency, a comparatively stable risk environment and improving investment income should encourage insurers to become more competitive.<sup>iii</sup>

#### Total Cost of Risk

The total cost of risk in the survey is measured by the sum of:

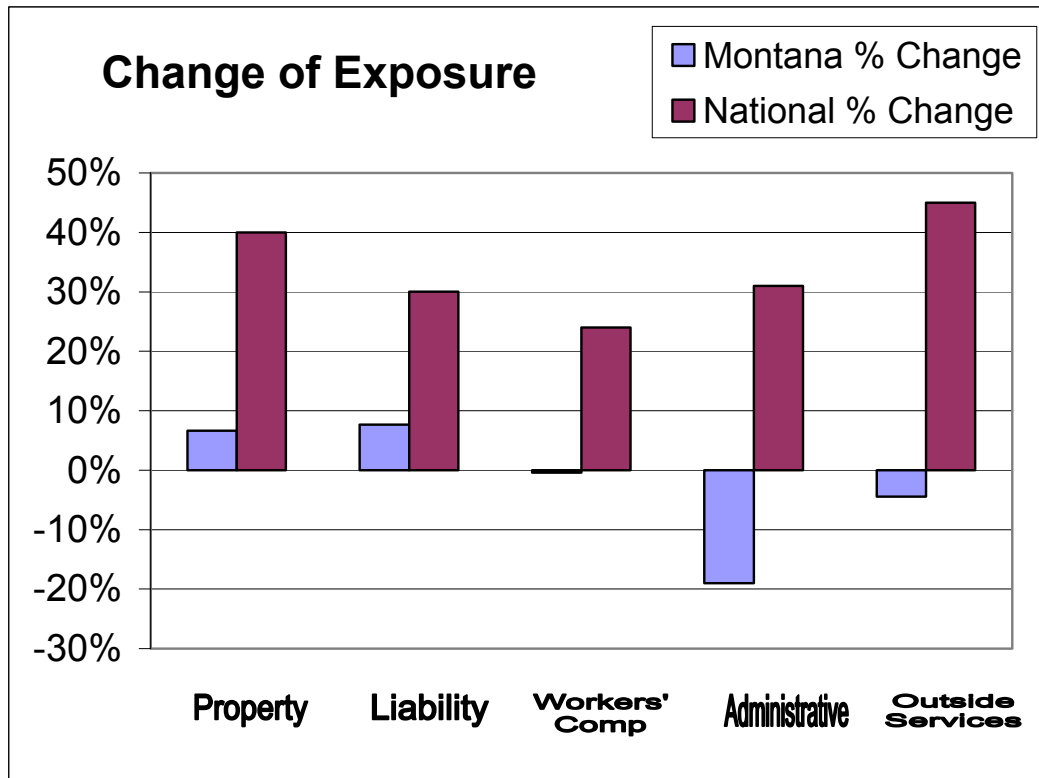
- 1) Insurance premiums for liability, property, and workers' compensation collected by the Risk Management & Tort Defense Division and the Montana State Fund;
- 2) Risk management/insurance department administrative budgets; and
- 3) Costs for outside services such as actuarial fees.

The term “cost of risk” refers to all costs associated with an organization’s risk management functions—namely, net insurance premiums, retained losses, risk control, and loss prevention expenses, and administrative costs.

In 2003, the average cost of risk for all U.S. respondents increased 34% from the previous year. Government entities also experienced an increase from the previous year, which was a result of higher liability and property costs. Montana did not follow the increasing government entity trend, Montana’s total cost of risk increased only 2% from FY2002. Montana’s total cost of risk in FY2002 was \$17,763,291 and \$18,066,913 in FY2003. The main factors contributing to the increase is an 8% increase in liability costs and 7% increase in property costs. Montana’s administrative costs decreased 19% from FY2002 to FY2003 while nationally the administrative cost of risk increased 31%. The schedule below illustrates changes by exposure for Montana’s total cost of risk.

<b>Exposure</b>	<b>FY2002</b>	<b>FY2003</b>	<b>Change</b>	<b>Montana % Change</b>	<b>National % Change</b>
Property	\$1,489,290	\$1,588,265	\$98,975	7%	40%
Liability	\$6,567,186	\$7,069,398	\$502,212	8%	30%
Workers' Comp	\$8,256,907	\$8,220,475	(\$36,432)	0%	24%
Administrative	\$1,351,415	\$1,094,673	(\$256,742)	-19%	31%
Outside Service	\$98,493	\$94,102	(\$4,391)	-4%	45%
<b>Totals</b>	<b>\$17,763,291</b>	<b>\$18,066,913</b>	<b>\$303,622</b>	<b>2%</b>	

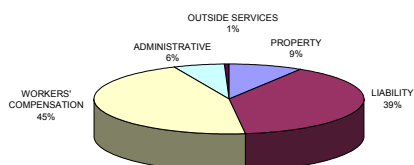
The survey shows that for all respondents nationally, all lines of exposure increased. Montana's cost did not follow the national trend by increasing in all areas; conversely Montana's costs decreased in all areas except property and liability costs, which had small increases, much less than the national trend. See the comparison graph below.



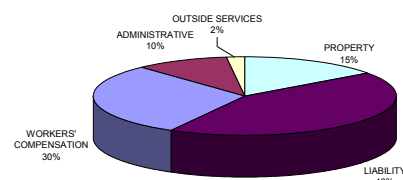
### Composition of the Cost of Risk Dollar

The composition of the cost of risk dollar shows what percentage of each risk dollar is spent on each type of exposure. The following pie charts and bar graph compare the State of Montana to other governmental entities participating in the survey.

Montana Composition of Cost of Risk Dollar

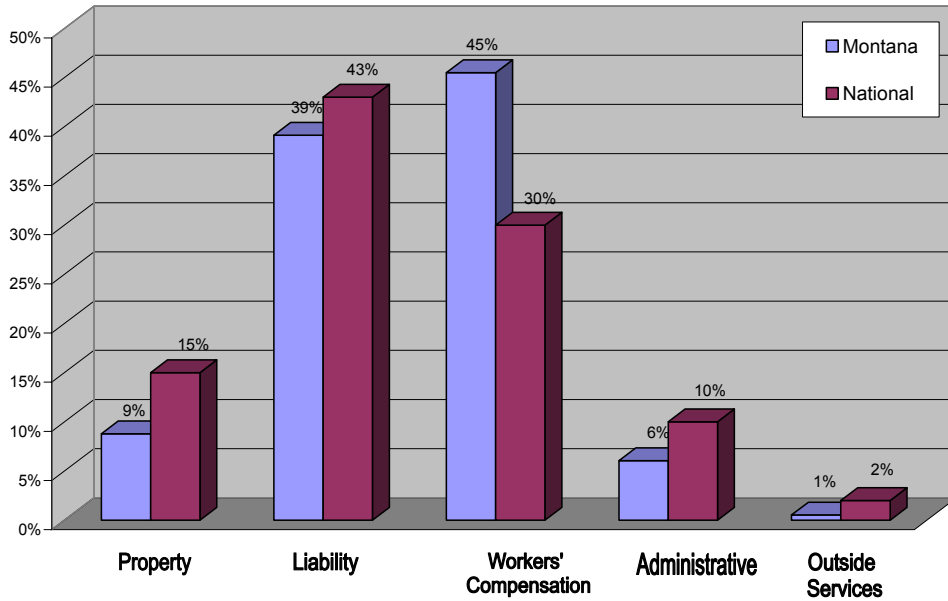


National Composition of Cost of Risk Dollar



Montana spends almost half of its cost of risk dollar on workers' compensation at 45%. However, Montana spends less on all other exposures than the national average, spending 9% on property and 39% on liability where the national trend is 15% on property and 43% on liability.

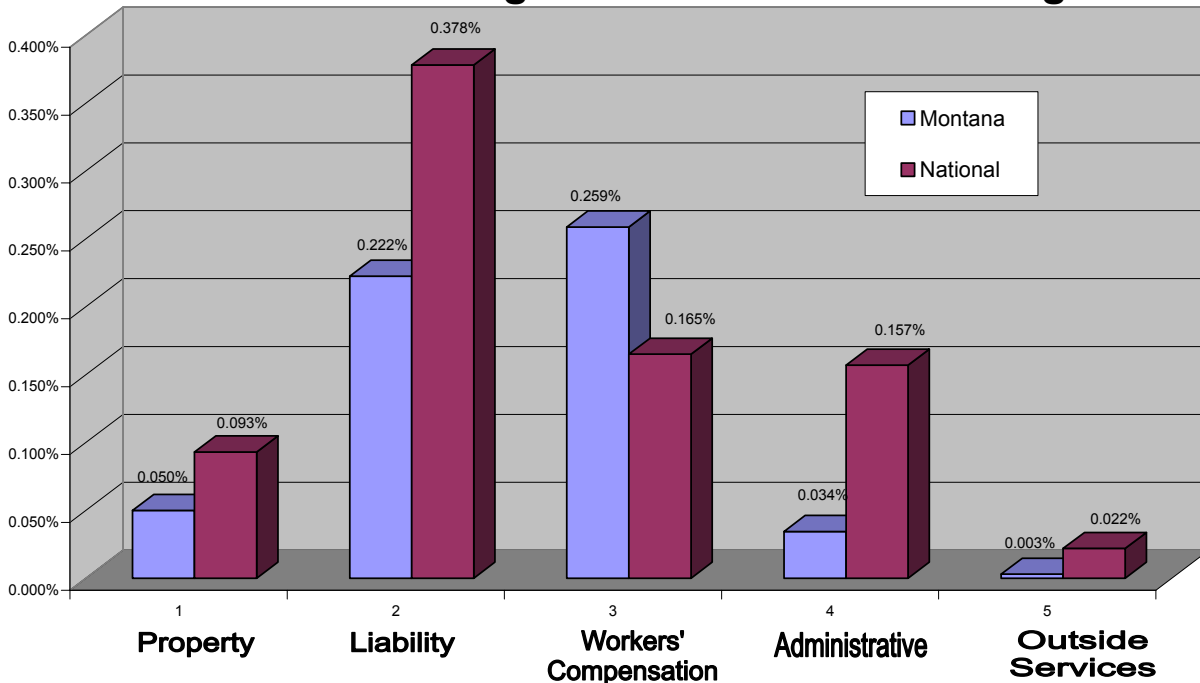
## Composition of Cost of Risk Dollar



### Risk Financing vs. Total Budget

The bar graph below compares the risk financing cost as a percentage of the total State of Montana operating budget to other government entities. The graph shows that Montana spent less of their total budget on cost of risk exposures in all categories. Montana's risk cost as a percentage of the entire state budget, including the university system, is 0.569%. Nationally, government agencies are using 0.644% of their operating budgets on the cost of risk.

## Risk Financing Cost as a % of Total Budget



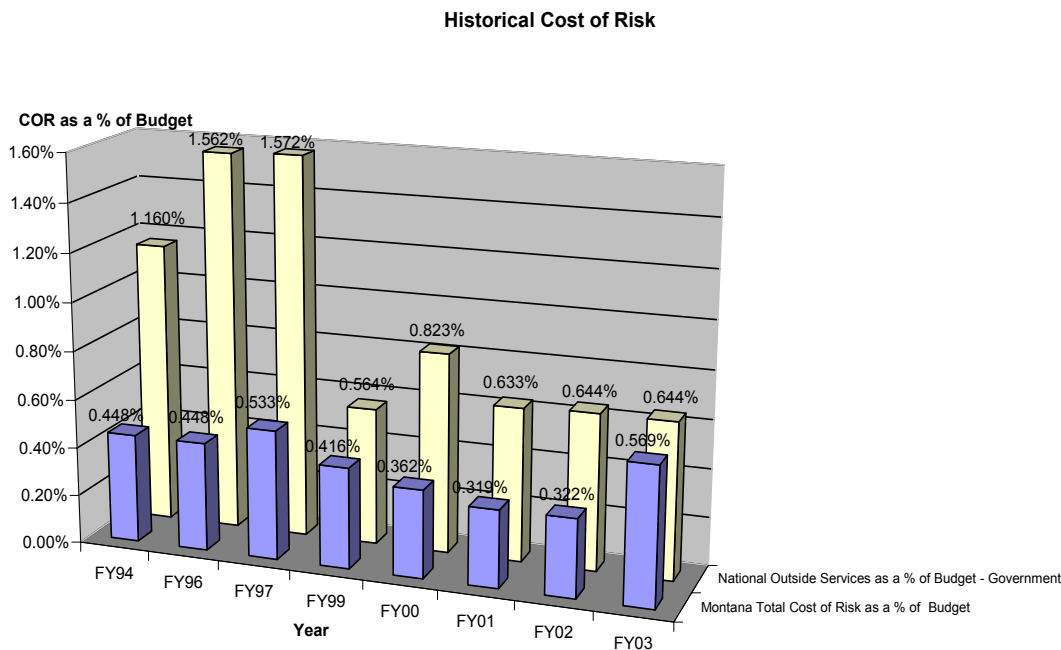
## Summary

As with any study, one has to be careful in drawing conclusions and recognize the limitations of the underlying data. The survey is based on questionnaire information presented to a variety of different entities. Each of these entities uses different data gathering techniques and assumptions, as well as having different operating objectives. The survey, however, is the best source of information currently available from which to draw conclusions. The 2003 survey received very few responses from large entities in the government section, which contributed to a significant change in demographics for government respondents. Florida, Louisiana, Montana, and Oregon were the only state participants.

Montana's total cost of risk as a % of its operating budget has increased slightly in 2003 due to a smaller operating budget and constant costs. In FY2003, we spent more of our cost of risk dollar on workers' compensation costs than the survey shows other governmental entities spent, and spent less of our dollar on property and liability exposures.

Montana is also consistent with one-third of government respondents whose property deductible/retention is between \$101,000 and \$250,000.

In terms of the amount spent on exposures as a percentage of the total budget, Montana spent less than the other governmental entities in the survey in every category measured. Overall, Montana spent 0.569% of the total operating budget on cost of risk and their counterparts spent 0.644% of their total budget on cost of risk last year and historically Montana has spent less, as illustrated in the charts below.



STATE OF MONTANA RISK MANAGEMENT & TORT DEFENSE DIVISION Cost of Risk Benchmarks								
LINE OF INSURANCE	FISCAL YEAR							
PROPERTY +								
	FY94	FY96	FY97	FY99	FY00	FY01	FY02	FY03
Property Premium Collected	\$1,112,546.17	\$1,260,964.00	\$1,270,721.00	\$1,310,236.00	\$1,328,867.00	\$1,341,755.00	\$1,439,288.00	\$1,536,765.00
Boiler Premium Collected	\$23,604.00	\$11,551.00	\$11,511.00	\$17,801.00	\$17,861.00	\$17,860.00	\$30,002.00	\$31,500.00
Fine Arts Premium Collected	included above	\$39,664.00	\$39,664.00	\$39,669.00	\$47,054.00	\$47,054.00	\$20,000.00	\$20,000.00
Total Property Premium Collected	\$1,136,150.17	\$1,312,179.00	\$1,321,896.00	\$1,367,706.00	\$1,393,782.00	\$1,406,669.00	\$1,489,290.00	\$1,588,265.00
Montana Risk Financing Costs as a % of Total Cost of Risk	6.607%	7.833%	8.273%	10.111%	10.747%	9.229%	8.384%	8.791%
National Risk Financing Costs as a % of Total Cost of Risk - Government	15.400%	5.760%	6.400%	16.000%	4.000%	5.000%	15.000%	15.000%
Montana Risk Financing Costs as a % of Budget	0.030%	0.033%	0.044%	0.042%	0.039%	0.029%	0.027%	0.050%
National Risk Financing Costs as a % of Budget - Government	0.117%	0.084%	0.110%	0.067%	0.057%	0.054%	0.093%	0.093%
LIABILITY +								
Liability Premium Collected	\$3,640,871.18	\$4,640,292.00	\$4,622,149.00	\$5,094,589.00	\$5,139,263.00	\$5,114,255.00	\$6,567,186.00	\$7,069,398.00
Total Liability Risk Financing Costs	\$3,640,871.18	\$4,640,292.00	\$4,622,149.00	\$5,094,589.00	\$5,139,263.00	\$5,114,255.00	\$6,567,186.00	\$7,069,398.00
Montana Risk Financing Costs as a % of Total Cost of Risk	21.172%	27.709%	28.927%	37.663%	39.627%	33.553%	36.971%	39.129%
National Risk Financing Costs as a % of Total Cost of Risk - Government	34.100%	36.350%	24.500%	32.000%	21.000%	31.000%	43.000%	43.000%
Montana Risk Financing Costs as a % of Budget	0.095%	0.124%	0.154%	0.157%	0.144%	0.107%	0.119%	0.222%
National Risk Financing Costs as a % of Budget - Government	0.303%	0.387%	0.360%	0.138%	0.113%	0.127%	0.378%	0.378%
WORKERS' COMPENSATION +								
Workers' Compensation Premium	\$11,880,094.00	\$10,148,502.00	\$9,411,968.00	\$6,344,490.00	\$5,540,818.00	\$7,517,161.00	\$8,256,906.84	\$8,220,475.00
Montana Risk Financing Costs as a % of Total Cost of Risk	69.084%	60.600%	58.903%	46.903%	42.723%	49.317%	46.483%	45.500%
National Risk Financing Costs as a % of Total Cost of Risk - Government	44.700%	54.500%	62.700%	45.000%	71.000%	57.000%	30.000%	30.000%
Montana Risk Financing Costs as a % of Budget	0.310%	0.271%	0.314%	0.195%	0.155%	0.157%	0.149%	0.259%
National Risk Financing Costs as a % of Budget - Government	0.452%	0.546%	0.622%	0.152%	0.502%	0.288%	0.165%	0.165%
ADMINISTRATIVE +								
Operations	\$509,408.00	\$575,674.00	\$550,515.00	\$662,234.00	\$769,873.00	\$1,069,541.00	\$1,351,415.00	\$1,094,673.00
Montana Operational Costs as a % of Total Cost of Risk	2.962%	3.438%	3.445%	4.896%	5.936%	7.017%	7.609%	6.059%
National Operational Costs as a % of Total Cost of Risk - Government	4.600%	2.800%	4.400%	3.000%	5.000%	7.000%	11.000%	10.000%
Montana Operational Costs as a % of Budget	0.013%	0.012%	0.018%	0.020%	0.022%	0.022%	0.024%	0.034%
National Operational Costs as a % of Budget - Government	0.141%	0.118%	0.134%	0.024%	0.050%	0.026%	0.157%	0.157%
OUTSIDE SERVICES =								
Actuarial	\$10,000.00	\$12,961.00	\$7,500.00	\$2,338.00	\$21,731.00	\$22,369.00	\$28,202.00	\$34,160.00
Appraisal	\$10,000.00	\$10,719.39	\$5,440.75	\$16,712.00	\$26,538.00	\$1,524.00	\$5,974.00	\$0.00
Adjusters	\$10,000.00	\$46,290.46	\$59,345.25	\$38,620.00	\$77,040.00	\$110,966.00	\$64,317.00	\$59,942.00
Total Outside Services	\$30,000.00	\$69,970.85	\$72,286.00	\$57,670.00	\$125,309.00	\$134,859.00	\$98,493.00	\$94,102.00
Montana Outside Services as a % of Total Cost of Risk	0.174%	0.418%	0.452%	0.426%	0.966%	0.882%	0.554%	0.521%
National Outside Services as a % of Total Cost of Risk - Government	1.200%	0.600%	2.000%	5.000%	0.000%	0.000%	2.000%	2.000%
Montana Outside Services as a % of Budget	0.001%	0.002%	0.002%	0.002%	0.003%	0.003%	0.002%	0.003%
National Outside Services as a % of Budget - Government	0.028%	0.019%	0.045%	0.045%	0.010%	0.015%	0.022%	0.022%
TOTAL COST OF RISK- MONTANA	\$17,196,523.35	\$16,746,617.85	\$15,978,814.00	\$13,526,689.00	\$12,969,045.00	\$15,242,485.00	\$17,763,290.84	\$18,066,913.00
Montana Total Cost of Risk as a % of Budget	0.448%	0.448%	0.533%	0.416%	0.362%	0.319%	0.322%	0.569%
National Total Cost of Risk as a % of Budget - Government	1.160%	1.562%	1.572%	0.564%	0.823%	0.633%	0.644%	0.644%
STATE OF MONTANA RISK MANAGEMENT & TORT DEFENSE DIVISION Cost of Risk Survey - Other Benchmarks								
Respondent profiles								
Demographic of All U.S. Respondents	First Quartile	Median	Third Quartile	Average	State of Montana			
Revenue Size/Operating Budget (\$ in Millions)	\$1,605	\$3,000	\$7,918	\$7,341	\$3,178			
Payroll Size (\$ in Millions)	\$219	\$404	\$882	\$1,004	\$905			
Total Insured Property Values (\$ in Millions)	\$552	\$1,509	\$4,508	\$3,823	\$2,432			
Number of Employees (FTEs)	5,485	10,761	16,750	20,476	19,950			
Number of Risk Management Dept. Employees (FTEs)	1.00	3.00	6.25	5.57	13.00			
Demographics of Respondents - Government								
Payroll Size (\$ in Millions)	\$37	\$75	\$300	\$191	\$905			
Total Insured Property Values (\$ in Millions)	\$106	\$250	\$393	\$588	\$2,432			
Number of Employees (FTEs)	720	1,754	3,199	3,238	19,950			
Number of Risk Management Dept. Employees (FTEs)	4.50	14.50	17.75	19.00	13.00			

<sup>i</sup> 2003 RIMS Benchmark Survey™ page 8.

<sup>ii</sup> 2003 RIMS Benchmark Survey™ page 22.

<sup>iii</sup> 2003 RIMS Benchmark Survey™ page 26.